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NO.

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM 1991

CHARLA GATES CANNON,

Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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QUESTIONS PRESENTED

The litigants in this income tax case tried and briefed the case in the issues of whether the stipulated expenses were deductible as business expenses or for the production of income. The Tax Court disallowed the expenses on the ground they were hobby losses. The Tenth Circuit affirmed. The questions presented are:

> Was it reversible error to sua sponte construe the hobby loss provisions in pari materia with those involving business expenses?
>
> Should the case be remanded to the Tax Court to afford petitioner the opportunity to offer evidence on the hobby loss issue?

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FOR THE TENTH CIRCUIT

Petitioner Charla Gates Cannon respectfully pray a Writ of Certiorari issue to review the Judgment of the Tenth Circuit Court of Appeals entered into this proceeding on November 15, 1991 and the denial of a Petition for Rehearing on January 13, 1992.

CITATIONS TO OPINIONS BELOW

The United States Tax Court entered its opinion reported in Tax Court Memo 1990-148. The Tenth Circuit Court of Appeals entered its opinion which has not reported to date.

JURISDICTION

Petitioner appeals from the judgment of the Tenth Circuit decided November 15, 1991. Petitioner's petition for rehearing was denied on January 13, 1992. Jurisdiction of this Court is invoked under 28 U.S.C. 1254 and 2101 and

Supreme Court Rule 10.

STATEMENT OF THE CASE

This case involves a taxpayer's treatment of losses incurred in connection with a Mexican gold and silver mining venture. In 1973, the taxpayer, Charla Cannon, joined a limited partnership ("Vemco") that was formed "to engage in the business of land development, exploration, mining and ore processing both in the United States and foreign countries." The Taxpayer provided Vemco with the funds necessary to conduct its business operations.

Vemco decided to invest in the Mexican venture at issue in this case in reliance upon the findings of an experienced miner who explored the sites and an engineer who analyzed and reported on the mining properties. Because Mexican law prohibits non-Mexican nationals or corporations from acquiring a majority interest in Mexican mining concessions, Compania Minera San Jose de Manzanillas, S.A. ("Manzanillas"), a Mexican corporation, held the mining concessions, and Vemco became a forty-nine percent shareholder in that corporation. In 1978, however, Vemco discovered that the president of Manzanillas had been embezzling, and the mining concessions were transferred to Memco, a different Mexican corporation. Although the taxpayer, through Vemco, expended over $800,000 for exploration and development of the mines, Memco never operated at a profit. Vemco did not report any income from mining for the years involved in this lawsuit, nor did it receive any dividends.

The taxpayer deducted her distributive share of the partnership losses claimed by Vemco on her federal income tax returns for 1976, 1977, 1978, and 1979. The Commissioner of Internal Revenue disallowed these deductions on

the grounds that the tazpayer did not establish that these amounts constituted ordinary and necessary business expenses or were for an activity entered into for profit or for the production of income.

The Tax Court agreed with the Commissioner's decision to disallow the deductions, but found the expenditures to be nondeductible under section 183 of the Internal Revenue Code. Because the Tax Court decided the case on the basis of a section that neither party raised explicitly, the taxpayer filed a motion for reconsideration, which was denied. The taxpayer appealed to the Tenth Circuit which affirmed holding:

"Here, the taxpayer contends that the Tax Court erroneously decided this case on the basis of a theory and Code provision (lack of profit motive and section 183) that neither party considered or raised, thereby surprising and prejudicing the taxpayer. According to the taxpayer, only three Code sections were at issue: sections 162, 212, 616. We disagree. Section 183 is interrelated to sections 162 and 212, profit motive being the common underlying theme. Indeed, as discussed *infra*, these provisions even reference each other. Accordingly, we find that the taxpayer in this case was adequately put on notice, was not prejudiced, and should not have been surprised." The Tenth Circuit affirmed and further refused to remand the case to the Tax Court for consideration and consolidation with subsequent years involving the same issue pending in Docket Number 4389-91.

REASONS WHY THE WRIT SHOULD BE GRANTED

I

The Tenth Circuit's statutory construction theory

that the sections of the Internal Revenue Code here involved are "naturally" interrelated, conflicts with the decisions of other Circuits.

Without congressional or judicial authority the Tenth Circuit has erroneously manufactured a "natural" implication that the interpretation of two sections of the I.R.C., Section 162 defining business expenses, and Section 212 involving expenses for the production of income, are naturally to be construed by considering the elements of the profit motive. Consideration of the origin and purpose of three statutes reveals the Tenth Circuit's error in statutory construction.

Section 162 was enacted in 1918 as Section 214 allowing as deductions "all the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business" and interpreted by this Court in *Kornhauser v. U.S.* (Sup Ct 1928) 276 U.S. 145, 6 AFTR 7358 allowing a deduction for attorney fees between partners. Section 212 was added to the Code in the Revenue Act of 1942 as section 23(a)(2) to allow deductions for non-business expenses incurred for the production of income and interpreted by this Court in *Bingham's Trust v Comm* (Sup Ct 1945) 325 U.S. 365, 33 AFTR 842 allowing a deduction for attorney's fees to a trust carrying on no business. This Court held the two statutes, 162 and 212 are to be construed with reference to each other. The applicability of these statutes was litigated and briefed by the parties in the instant case.

However, the Tax Court, with affirmance by the Tenth Circuit, sua sponte held Section 183 of the Internal Revenue Code was decisive. Section 183 was enacted in 1969 to disallow hobby losses in excess of gross income. The accompanying Senate Report to H.R. 13270, 1st

Section 103 is set forth in Appendix E the pertinent part of which follows:

> "The committee is concerned, however, that requiring a taxpayer to have reasonable expectation" of profit may cause losses to be disallowed in situation where an activity is being carried on as a business rather than as a hobby. Accordingly, the committee has modified the house bill to provide that in determining whether losses from an activity are to be allowed, the focus is to be on whether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit. This will prevent the rule from being applicable to situations where many would consider that it is not reasonable to expect an activity to result in a profit even though the evidence available indicates that the activity actually is engage in for profit. For example, it might be argued that there was not a "reasonable" expectation of profit in the case of a bona fide inventor or a person who invests in a wildcat oil well. A similar argument might be made in a case of a poor person engaged in what appears to be an inefficient farming operation. The committee does not believe that this provision should apply to these situations on that the House intended it to so apply, if the activity is engaged in for profit.

Consequently, as passed, Section 183(c) expressly excluded items deductable as business expenses under Section 162 or for the production of income under Section 212. The statute provides: "For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212." No changes were made in sections 162 or 212. Thus the Tenth Circuits holding that three sections are entwined was patently erroneous. Neither Section 162 or 212 refer to or are limited by Section

183; the latter's applicability kicks in, if at all, only if the former sections are not applicable. This case was litigated under one theory and erroneously decided and affirmed under an entirely different issue.

Other circuit courts have uniformly rejected the Tenth Circuit's approach. The Eight Circuit in *Comm v Transport Manufacturing and Equipment Co* (8th Cir 1973) 478 F2d 731, 31 AFTR 2d 73-1247 approved the Tax Court's refusal to consider an issue not raised at trial, stating, "The Commissioner should notify the taxpayer of the particular Code section, regulation or theory involved in a case to avoid prejudice to the taxpayer." The Third Circuit in *Baird v. Comm* (3rd Cir 1970) 438 F2d 490, 26 AFTR2d 70-5799 held: "Although the Commissioner may suggest additional theories of liability during the hearing, it is impermissible for the Tax Court to decide the case on an issue other than that *explicity* tendered without reasonable notice to the taxpayer" (Emphasis Added). In like manner the Ninth Circuit in *Ah Pah Redwood Co v Commissioner* (9th Cir 1957) 251 F2d 163, 1 AFTR2d 456 reversed and remanded the case where neither of the parties had addressed the issue although the Tax Court had. In *Edison Securities Corporation* the 4th Circuit in an opinion reported at 78 F2d 85, 16 AFTR 307, expressed the proper judicial standard when the trial court sue sponte raised the theory on which the case was decided, stating:

> "In the pending case, however, the new matter was not introduced by the parties but by the Board itself, and the subsequent course of the proceedings should have been shaped with this circumstance in mind. A sharp issue was raised as to a point upon which the parties had theretofore agreed, and although some evidence bearing on the subject had been put in the record in connection with the other transactions, it was obviously inadequate for the pur-

> pose now under discussion, for the Board itself said that it was difficult to tell from the available facts what had taken place. In this emergency, the Board might well have ordered a rehearing upon its own motion, and in any event, should have granted the Commissioner's motion to that end."

Furthermore, allocation of the burden of proof with regard to the new theory would be necessary as neither party has ever raised the issue except the Tax Court itself. *Clark v Commissioner,* 266 F2d 698, 3 AFTR 2d 1333 (9th Cir. 1959); *Tex-Penn Oil Co. v Commissioner,* 83 F2d 518, 17 AFTR 518 (3rd Cir. 1936) ("In view of these changes of front, we submit that any presumption of correctness which originally attached to the Commissioner's formal determination has now disappeared completely").

The Tenth Circuit has thus created a confusing precedent, likely to generate further confusion among the other Circuits. It is a precedent directly at odds with the prior appellate decisions.

II

> The decision below affirming the Tax Court's decision rather than remanding the proceeding conclusively denied petitioner her day in court, a fundamental injustice.

In its opinion the Tenth Circuit expressly acknowledged that Section 183 was not considered by the litigants. Rather than outright reversing the Tax Court the tenth Circuit applied Section 183 and the nine factors listed thereunder in Treasury Regulation 1.183-2(b) concluding that were it considering the issue de novo it might well have reached a different conclusion, however, the Tax

Court's finding of fact was not clearly erroneous. All of this without petitioner presenting evience of the Section 183 factors.

If the Supreme Court concludes this case should not be reversed, it is well resolved under its own standards that the case should be remanded to afford petitioner the opportunity to present evidence directed towards Section 183. In *Hormel v Helvering* (Sup Ct 1941) 312 U.S. 552, 25 AFTR 1198, the issue related to the definition of income. Subsequent to the trial court proceeding the Supreme held such trust income was taxable in *Clifford v. U.S.* However, the Supreme Court remanded *Hormel* to the trial court to allow the taxpayers to present evidence on the issue, stating, "Under these circumstances we do not feel that petitioner should be foreclosed from all opportunity to offer evidence before the Board on this issue, however remote may be his chance to take his case out of the Clifford rule."

This principle of jurisprudence was well expressed by the ~~Third~~ Circuit in *Baird v Commissioner* (3d Cir 1970) 438 F2d 490, 26 AFTR2d 70-5799 and in the First Circuit in *Little v Commissioner* (1st Cir 1960) 273 F2d 746, 5AFTR2d 492. In *Baird* the Court remanded for consideration of the new issue. In *Little* the Court held that remanding would be appropriate to allow the taxpayer to introduce evidence on the new theory advanced by the government, however, in oral argument appellant's attorney conceded no additional evidence was available. In the instant case appellant has ample evidence to respond to the Regulations nine factors, she simply seeks the opportunity to do so.

In view of the conflict of the decision below with the past decisions of this Court, the Supreme Court may wish to consider summary reversal.

CONCLUSIONS AND PRAYER

Because of the importance and broad application of these issues in Federal tax cases, the petitioner prays that this Court grant a Petition of Certiorari to the United States Supreme Court.

Respectfully submitted,

TOWNER SHIELDS LEEPER

APPENDIX A

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * * *

SEC. 183 [as added by Sec. 213(a), Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487]. ACTIVITIES NOT ENGAGED IN FOR PROFIT.

(a) *General Rule.*—In the case of an activity engaged in by an individual or an electing small business corporation (as defined in section 1371(b)), if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) *Deductions Allowable.*—In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) *Activity Not Engaged in for Profit Defined.*—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) *Presumption.*—If the gross income derived from an activity for 2 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary or his delegate establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting the perior of 7 consecutive taxable years for the period of 5 consecutive taxable years.

* * * * *

SEC. 212 EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

APPENDIX B

COPY

UNITED STATES TAX COURT

CHARLA GATES CANNON,	)	
	)	
Petitioner,	)	
	)	
	)	Docket No.
	)	2261-85
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed March 20, 1990, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years 1978 and 1979 in the amounts of $120,334.60 and $101,980.00, respectively.

(Signed) W.M. DRENNEN

Judge

Entered: JUL 10 1990

COPY

UNITED STATES TAX COURT

CHARLA GATES CANNON,	)	
	)	
Petitioner,	)	
	)	
	)	Docket No.
	)	9671-82
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed March 20, 1990, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years 1976 and 1977 in the amounts of $155,221.20 and $244,581.83, respectively.

(Signed) W.M. DRENNEN

Judge

Entered: JUL 10 1990

APPENDIX C

T. C. Memo. 1990-148

UNITED STATES TAX COURT

CHARLA GATES CANNON, Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE,
Respondent

DOCKET NOS. 9671-82, 2261-85.

Filed March 20, 1990.

Towner Leeper, for the petitioner.

John F. Eiman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DRENNEN, *Judge*:[1] In two separate notices of deficiency, respondent determined deficiencies in petitioner's income tax for the taxable years and in the amounts shown below:

Year	Amount
1976	$156,531
1977	245,576
1978	123,155
1979	106,628

[1] This case was assigned and deemed submitted to Judge Drennen by order dated June 6, 1989.

Petitioner filed two petitions, one for the years 1976 and 1977 (docket No. 2671-84) and one for the years 1978 and 1979 (docket No. 2261-85). The issues in both dockets were similar so the cases were consolidated for trial, briefs, and opinion.

The parties filed stipulations of facts and the facts stipulated therein are so found.

After concessions by petitioner, the remaining basic issue is whether petitioner is entitled to deduct amounts of money she allegedly paid, through Vemco, a limited partnership in which she was a limited partner, in connection with a gold and silver mining venture in Durango, Mexico, during each of the years at issue. More specifically, the issues are:

(1) Whether the mining venture was an activity not engaged in for profit by and through Vemco within the meaning of section 183(a);[2]

(2) Whether the funds advanced to two Mexican corporations, by and through Vemco, were nondeductible shareholder contributions to the Mexican corporations or were deductible expenses of a joint venture between Vemco and the Mexican Corporations;

---

[2] All Rule references are to the Tax Court Rules of practice and Procedure. All section references are to the Internal Revenue Code of 1954, as amended and in effect for the years at issue.

(3) Whether amounts paid by Vemco to persons other than the Mexican corporations in connection with the exploration, development, and operations of the mining concessions constituted nondeductible capital contributions to the Mexican corporations;

(4) Whether the expenditures, if not capital contributions, were paid in connection with mining development (section 616 IRC) or mining exploration (section 617);

(5) Whether all of the aforementioned expenditures were ordinary and necessary;

(6) Whether petitioner has substantiated all of the amounts and the nature of the aforementioned expenditures; and

(7) Whether the application of section 482 reduces Vemco's (and petitioner's distributive share of) claimed inventory loss to zero for the taxable year 1976.

FINDINGS OF FACT

Petitioner, Charla Cannon, was a widow who lived in Denver, Colorado. She had a large annual income, primarily from various trusts established by her family, and from her deceased husband's estate, and various other benefits provided under bonus and pension plans by her deceased husband's former employer, Beatrice Foods Co. She had no education or experience in mining or engineering, except what she might have gleaned from her father, who was a mining engineer. She was 67 years of age at the time of trial in 1986. She received a junior college education at Bennington College in New York. She was engaged in several

businesses prior to becoming involved in Vemco, including Cannon Aeronautical Center, raising sheep in Wyoming, a health spa for women, and selling helicopters in Colorado.

In 1973 petitioner became involved with a limited partnership, Vemco, in which she was a 54 percent limited partner. Vemco was a Texas limited partnership formed by Ramon Perez Madrid. The limited partnership was reconstructed under the same name in 1975. The limited partnership then consisted of Hersey W. Young, Jr. and Harold B. Young, general partners, and Charla G. Cannon, H. R. Chrisman, M.D., and Carl W. Weaver, limited partners.

The limited partnership agreement executed in 1975 set forth the purpose for Vemco which was "to engage in the business of land development, exploration, mining and ore processing both in the United States and foreign countries." This limited partnership agreement was amended again as of January 1, 1978. It recited that subsequent to the establishment of the partnership it needed additional funds to conduct its business operations, and Cannon had provided those funds; also that Cannon was willing to "provide further contributions to the partnership as requested by the general partner" provided the agreement was executed. It stated further that because of the agreement of Cannon to contribute additional capital to the partnership while the other partners were not contributing a significant additional capital or services, it was agreed that the allocation of profits of the partnership, as well as the proceeds in the event of sale or disposition of the partnership assets, should be allocated as follows:

Name	Percentage
Charla G. Cannon	45%
Hersey W. Young, Jr.	30%
H. R. Chrisman, M.D.	9%

Carl W. Weaver	8%
Harold B. Young	8%

It was also agreed that the annual expenses and losses of the partnership would continue to be allocated to Cannon insofar as her capital account permitted. All of the expenses of the mining ventures, which were paid by petitioner through Vemco, were allocated to petitioner during the years here involved. Hersey W. Young, Jr. was designated to be the sole general partner with Harold Young, Cannon, Weaver, and Chrisman being limited partners. Harold B. Young resigned as a general partner.

In about 1970 Madrid acquired all the mining concessions for three mining claims, Ampl. de San Jose, San Jose, and Tres de Mayo, which were located in Sierra Madre Occidental Mountain range in the State of Durango, near the village of Manzanillas, in the Republic of Mexico. Madrid started working these claims prior to 1973.

The three San Jose mines were located in very mountainous country, near Durango, Mexico, at an elevation of 6,000 to 6,500 feet above sea level. The terrain is rough and the hillsides are very steep and roads are on a contour. Manzanillas is the nearest village. A very primitive road connecting Manzanillas and Topia, extending about 35 kilometers in length, was in place in 1973. The mines had been opened and worked by hand through shafts and tunnels. Gold and silver were found in veins extending underground.

Carl Weaver, an experienced miner and a limited partner in Vemco, entered into an agreement with Madrid in 1973 whereby Weaver paid Madrid $300 per month for the right to conduct exploration activities for a limited time at the site of the Madrid mining concessions. In return, Madrid obligated himself to transfer the mining concessions to a Mexican mining corporation at Weaver's request. After spending approximately 30 days at the

mining site, Weaver prepared and submitted a report on the San Jose mining properties to Hersey Young, Vemco's general partner and a long time business associate of petitioner. In his report, Weaver estimated that the mine had been in operation since 1913 and that the ore in the mine (gold and other metals) was obvious, being exposed in the face of the mine. Weaver estimated that with proper development the mines had a potential production of 50 tons per day, although the small, very primitive mill on the property could not mill more than three tons in 24 hours. Weaver recommended the on-site installation of a larger capacity mill because the cost of freight to transport ore to the nearest smelter was about $100 per ton. Weaver also reported that the per ton ore values of various ore samples taken from the Taonita vein (located approximately one-half mile south of the San Jose mine) averaged between 0.7 and 1.0 ounces of gold and 9.0 ounces of silver.

Vemco's decision to invest in the mining concessions was based on Weaver's findings and on the findings of an engineer, Henry P. Ehrlinger (deceased at the time of the trial), whom Young retained to analyze and report on the mining properties. Ehrlinger was a professor of mining and engineering at the University of Texas at El Paso with much experience in mining activities in Mexico.

Ehrlinger visited the mine and subsequently sent Ralph Wilcox, Jr., then a graduate geology student at the University of Texas at El Paso, to the location of the mining claims. Wilcox prepared a report, dated April 1975, which included the assay results of the ore samples taken from the areas in which Manzanillas Corporation held mining concessions. In his discussion of Taonita, Wilcox revealed the following assay results of certain ore samples:

Description	Ounces of Gold Per Ton	Ounces of Silver Per Ton
Channel sample	0.04	0.76
Channel sample	0.28	6.04
Quartz vein	0.04	0.60

The report also included a discussion of the Tres de Mayo mine and contained the following assay results of three channel samples taken at or near the mine:

Description	Ounces of Gold Per Ton	Ounces of Silver Per Ton
N 1 Entrance, first level	0.34	3.16
N 2 Second level, rear	0.04	0.58
N 3 Third level, rear	0.96	13.18

Wilcox's report also included the following comments regarding the mill located below Manzanillas: "At current crushing capability, the mill can process about one ton per day with about 60% recovery of precious metals. The crusher is old and failing."

Ehrlinger prepared a mining report, dated May 1975, which included Wilcox's findings. Ehrlinger's report contained profit projections based on 50 tons of ore mined daily and a respective gold and silver ore grade of 0.70 and 9.0 troy ounces per ton of ore mined. Total monthly expenses were projected at $99,011.68. Of these monthly expenses only one, income taxes of $18,117.68, varied with changes in profitability. All other expenses, fixed or variable, were unaffected by changes in the precious metal ore grade per ton of ore mined. Ehrlinger's report projected a monthly

ore mining operationg rate of 1,200 tons and a "net calculated monthly profit" of $50,172.32 if properly exploited.

Ehrlinger's report also contained a copy of the El Paso Chemical Laboratories report addressed to Ehrlinger. The El Paso Chemical Laboratories report contained the assay results of 12 ore samples, partially reproduced below:

RESULTS

Sample	Designation	Gold oz/ton	Silver oz/ton
N-1	RW-T-14	0.04	0.60
N-1	RW-N-1	0.34	3.16
N-1	RW-M-19	0.01	0.33
N-1	RW-T-10	0.03	0.49
N-1	RW-T-15	0.04	0.60
N-1	RW-T-21	0.28	6.04
N-1	RW-F-1	0.03	0.63
N-1	RW-M-24	0.01	0.33
N-1	RW-N-3	0.96	13.18
N-1	RW-N-2	0.04	0.58
N-1	RW-T-8	0.04	0.46
N-1	RW-T-13	0.04	0.76

Ehrlinger's report further included various mineral descriptions, prepared by Wilcox, of the 12 ore samples, including the location from which they were extracted, most of which were from either Tres de Mayo or Taonita.

Petitioner read both Weaver's and Ehrlinger's reports. Petitioner had known Weaver for some time and had confidence in his metallurgical knowledge. She read his

report on the San Jose mining properties and agreed to make an investment therein. After petitioner read Ehrlinger's report, which predicted a net profit of $50,172.32 per month if the mines were properly developed with an adequate mill, she was willing to invest more in the project.

Vemco also became interested in the mining concessions as a potential investment. Vemco entered into an agreement with Madrid that Madrid would put his mining interests into a corporation or partnership and that Vemco would put up the money to cover the costs of defining and developing the mines, which would be repaid first out of the profits from the mine with the balance of the profits being divided equally between them.

After petitioner learned from her Mexican legal counsel that Mexican law prohibits non-Mexican nationals or corporations from acquiring a majority interest in Mexican mining concessions, the interested individuals decided that a corporate ownership was the legal mechanism which would best facilitate indirect ownership of the mining concessions. Madrid later transferred his mining concessions to a Mexican corporation, known as Compania Minera San Jose de Manzanillas, S.A. (Manzanillas). Subsequent to the transfer Vemco became a 49 percent shareholder in Manzanillas. The remaining 51 percent was issued to Mexican nationals. However, because of further Mexican law requirements, the stock representing Vemco's 49 percent was issued in the name of petitioner, and Hersey W. Young, Jr., for the benefit and on behalf of Vemco.

Madrid was president of Manzanillas until 1978. Madrid supervised the mining and milling activities of Manzanillas at the site of the mining claims. He testified that during the time he worked the claims all the extraction was done by hand. Madrid sold in his own name and in the

name of Manzanillas gold and silver extracted from the claims. During 1974-1978, Madrid deposited at least $47,288 of total sale proceeds either into his personal or Manzanillas' bank accounts. After this embezzlement was discovered, Young "fired" Madrid in 1978. Subsequently, Young successfully brought suit against Madrid to recover these amounts.

In 1976 and 1977, Vemco, acting through Young, contracted with third parties for the construction of roads and tunnels on the sites of the mining concessions and paid for the work with its own funds. It also contracted with Juan Sanchez to explore, repair and prepare the mining property of the Manzanillas' company. These contract expenditures were claimed by Vemco as exploration-development expenses, and totalled $165,827 in 1976, $335,584 in 1977, $180,000 in 1978, and $125,460 in 1979.

In 1978 Memco S.A. de C.V. (Memco), was formed and the owner of Mexican mining concessions adjacent to the Madrid concessions, Raul Olguin Lopez (Lopez), subsequently transferred his mineral interests to Memco. Lopez was the president of Memco. Vemco was granted an option to acquire 49 percent of Memco's stock (Class B) in exchange for an agreement to explore the mining claim. The remaining 51 percent of Memco's stock (Class A stock) was subscribed for by Mexican nationals. On the same date Vemco contracted with Sanchez for exploration of the mining claim at a cost not to exceed $180,000. Memco was to reimburse Vemco for the cost of exploring the mine with the profits earned from Memco's operations. Memco never operated at a profit.

There was never any core drilling on any of the above mentioned mining claims. A rather basic procedure was used to extract and separate the gold from the mines.

Activity at the mines was curtailed, to some extent, after it was discovered in 1978 that Madrid had been selling the ore for his own account.

Romelia Carpenter has been nvolved in the actual preparation of Vemco's tax returns since 1978. Carpenter has also prepared various financial schedules of Vemco's accounting data relating back to 1973. At trial, Carpenter testified that, when available, she used source documents in preparing the financial schedules. But in certain situations, payments made under contract did not flow through Vemco's regular checking account. In those situations, Carpenter used the contract itself as a source document and relied upon oral verification that payment thereunder had been made.

Vemco did not report any income from mining on any of its tax returns for the years here involved. Neither Manzanillas nor Memco has ever paid a dividend to Vemco.

The parties have stipulated that Vemco paid or incurred certain expenses in the years 1976, 1977, 1978, and 1979, which produced the losses claimed by Vemco in its tax returns for those years. Petitioner, by virtue of the limited partnership agreement, claimed these losses as Schedule E partnership losses. In his notices of deficiency, respondent determined the extent to which the amounts claimed by petitioner, through Vemco, should be disallowed. Those amounts disallowed by respondent totalled $187,173.96 for 1976, $354,608.29 for 1977, $214,078.00 for 1978, and $152,415.00 for 1979. The principal amounts disallowed by respondent were deductions claimed for each of those years for "exploration development" expenses which totalled $165,827.35 for 1976, $335,584.16 for 1977, $180,000.00 for 1978, and $125,460.00 for 1979. Vemco deducted these expenses on its tax returns for 1976

through 1979, labelling the 1976-1979 amounts as "development" expenses. Vemco also deducted additional expenses such as travel, vehicle, rent, etc. in the total amounts of $25,124.99 for 1976, $20,866.46 for 1977, $36,308.00 for 1978, and $28,889.00 for 1979. Of those amounts, $21,346.61 for 1976, $19,024.40 for 1977, $2,230.00 for 1978, and 1,934.00 for 1979, were included as part of the total amounts disallowed by respondent.

In his notices of deficiency, respondent set forth the following alternative grounds upon which he based his aforementioned determinations. Respondent does not agree that the amounts were expended for the purposes designated nor does respondent agree to the characterization of the amounts. Respondent also contends that the amounts claimed as deductions by Vemco represent amounts paid or incurred in connection with an activity not engaged in for profit. Alternatively, respondent argues that the amounts claimed as deductions by Vemco constituted nondeductible capital contributions to either Manzanillas or Memco inasmuch as the amounts were paid by Vemco, their shareholder, on the corporations' behalf for corporate expenses.

Inventory Issue

Cannon Aeronautical, Inc. ("Aero"), of which petitioner was majority owner, was liquidated in 1975, and certain of its assets (copper wire and airplane parts) were distributed by Aero, as debtor, to petitioner, as creditor, in partial satisfaction of a loan. Petitioner then transferred these assets to Vemco and received a credit to her capital account of $54,850, which was the book value of the assets on Aero's books at the time they were distributed to Vemco. The principal asset distributed was 275,000 feet of 20-strand copper wire recorded by Aero at a cost of

$41,250. It had been purchased by Aero in 1970 and was obsolete at the time of the transfer to Vemco and had only scrap value. All of the assets transferred were entered on Vemco's books at the cost reflected on Aero's books. In 1976 Vemco sold certain miscellaneous parts and supplies for $1,500. In 1976 it wrote down the value on the books of the remainder of these assets by a total of $42,250, $33,000 of which was attributable to the copper wire. On its returns for 1976 Vemco claimed cost of goods sold for these assets in the amount of $42,500, including the $1,500 worth that were sold. Of the $42,500, cost of goods sold claimed, $40,750 was attributable to the assets which were not sold in 1976. Respondent disallowed $40,750 of this claimed cost of goods sold expense. Respondent also determined that a $12,600 date of acquisition fair market value should be allocated to the inventory assets.

OPINION

The parties have stipulated that Vemco paid or incurred certain expenses claimed as deductions on its tax returns for the years in question. The expenses claimed as deductions by Vemco generally fall into three broad categories: (1) amounts Vemco contributed directly to the two Mexican corporations, Manzanillas and Memco, who, in turn, allegedly paid out the contributions in connection with the exploration and development of their respective mining concessions; (2) amounts Vemco paid directly to third parties under contract in connection with the exploration and development of the Mexican mining concessions; and (3) amounts Vemco paid to others for the purchase of equipment and in the form of salaries, professional fees and overhead expenses as these amounts relate to the mining activities of the Mexican corporations.

Petitioner contends that all of the amounts she paid

out in connection with the mining activities are deductible under either section 162, 165, 212, 616, or 617. At trial, respondent reiterated the alternative bases, as set forth in his notices of deficiency, *supra*, upon which he determined the extent to which petitioner's claimed deductions should be disallowed.

First, the record does not support a finding that either petitioner or Vemco were directly engaged in the business of mining gold and silver in Mexico. So none of the expenses claimed by petitioners are deductible under section 162, which requires that they be paid or incurred in carrying on a trade or business. For the same reason none of those expenses are deductible by petitioner under section 165 as losses. If those expenses are deductible at all they must be deductible under section 212(1) as ordinary and necessary expenses paid or incurred for the production or collection of income, or under section 616 as mining development expenses or section 617 as mining exploration expenses.

A basic requirement under all of the above provisions is a showing that the activity giving rise to the expenditure was engaged in by petitioner with the objective of making a profit. *Horn v. Commissioner*, 90 T.C. 908, 933 (1988); *Patin v Commissioner*, 88 T.C. 1086, 1116 (1987). Similarly, a deduction under section 617 depends upon a showing that the mining activities constituted a trade or business or were undertaken and carried on for the production of income. *Patin v. Commissioner, supra* at 1117, which, in turn, also depends upon a showing of a bona fide profit objective.

Furthermore, section 183(a) provides the general rule that if an individual engages in an activity, and "if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except

as provided in this section." Section 183(b) provides for the following exceptions to section 183(a) nondeductibility: (1) Deductions which would be allowable without regard to whether such activity is engaged in for profit shall be allowed, section 1.183-1(b)(1), Income Tax Regs.; and (2) deductions which would be allowable only if such activity is engaged in for profit shall be allowed "but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1)." Section 183(b)(2). Section 183(c) defines an activity not engaged in for profit as follows:

> (c) ACTIVITY NOT ENGAGED IN FOR PROFIT DEFINED.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

Where a partnership is involved, whether an activity is engaged in for profit is determined at the partnership level and not at the partner level. *Brannen v. Commissioner*, 78 T.C. 471, 505 (1982), affd. 722 F.2d 695 (11th Cir. 1984); *Siegel v. Commissioner*, 78 T.C. 659, 698 (1982). If a partnership activity is not engaged in for profit by the partnership, all partners are denied deductions affected by section 183. See *Flowers v. Commissioner*, 80 T.C. 914, 932 (1983); see also *Brannen v. Commissioner*, *supra* at 505.

The determination that an activity is engaged in for profit is one of fact to be resolved on the basis of all the facts and circumstances. *Flowers v. Commissioner*, *supra* at 931-932. A reasonable expectation of profit is not required as long as there is a bona fide objective to realize a profit. *Golanty v. Commissioner*, 72 T.C. 411, 425-426 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981). Profit means economic profit, independent of

tax savings. *Landry v. Commissioner*, 86 T.C. 1284, 1303 (1986).

In determining the partnership intent, we have often focused on the actions taken by the promoters and general partners, including their intent, knowledge, conduct, expertise, and all other factors they relied upon in making decisions for the partnership. *Surloff v. Commissioner*, 81 T.C. 210, 233 (1983); *Finoli v. Commissioner*, 86 T.C. 697, 722 (1986); *Brannen v. Commissioner, supra*. However, this does not mean that our inquiry is confined solely to the activities of the partnership, "for those parties possessing resources sufficient to acquire and exploit investment property are not always blessed with corresponding expertise." *Flowers v. Commissioner, supra* at 932. The scope of the relevant inquiry therefore permeates the entire profit objective issue must still be assessed from the perspective of the partnership. *Flowers v. Commissioner, supra* at 932. Petitioner bears the burden of proving the required profit objective. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); Rule 142(a).

Section 1.183-2(b), Income Tax Regs., sets forth several relevant factors which are to be considered in determining whether an activity is engged in for profit. Among them are: (1) The manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or

recreation are involved.

Objective facts are accorded greater weight than are mere statements of intent. *Engdahl v. Commissioner*, 72 T.C. 659, 666 (1979). No one factor is determinative of the taxpayer's objective to make a profit. Section 1.183-2(b), Income Tax Regs. However, a record of substantial losses over many years and the unlikelihood of achieving a profitable operation are important factors bearing on the taxpayer's true objective. *Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965), affd. 379 F.2d 252 (2d Cir. 1967). As we stted in *Bessenyey v. Commissioner, supra* at 274:

> the presence of losses in the formative years of a business, * * * is not inconsistent with an intention to achieve a later profitable level of operation, bearing in mind, however, that the goal must be to realize a profit on the entire operation, which presupposes not only future net earnings but also sufficient net earning to recoup the losses which have meanwhile been sustained in the intervening years.

After a review of the record before us, we are convinced that Vemco did not enter into the mining activity with the objective to make a profit. Nor does it appear, for the reasons stated below, that the mining activity was potentially profitable because it is unlikely that it could "recoup the losses which have meanwhile been sustained in the intervening years." *Bessenyey v. Commissioner, supra* at 274.

Vemco's decision to enter into the mining activity was ostensibly based on the $50,172.32 net calculated monthly profit projection contained in Ehrlinger's report. These profit projections assumed, inter alia, that an ore grade of 0.70 troy ounces of gold and 9.0 troy ounces of silver could be realized per ton of ore mined. However, the

quality of ore grades used in these profit projections were inconsistent with the data that was available at the time the projections were made. The El Paso Chemical Laboratories report contained the results of the 12 ore samples. The results of these 12 samples indicated an average of 0.155 ounce of gold and 2.263 ounces of silver per ton of ore. Moreover, the results of the six samples contained in Wilcox's report indicated per ton averages of 0.12 ounces of gold and 2.467 ounces of silver and 0.447 ounces of gold and 5.64 ounces of silver for Taonita and Tres de Mayo, respectively. Use of the samples' highest average ore grade values in Erhlinger's profit formula, all other values remaining constant including the assumed operationg rate of 50 tons per day, results in a projected cash flow from the mining operations which falls short of even achieving/attaining the break-even point, much less a profit.

The record also contains information concerning the mining activities for a period of 11 years, 1973-1983. Neither of the Mexican corporations ever paid a dividend to Vemco. Vemco reported losses in each and every of the 11 years for a total loss in the amount of $2,205,045.10. A record of such losses over so many years is persuasive evidence that Vemco did not possess the requisite objective of making a profit. Sec. 1.183-2(b)(6), Income Tax Regs.; *Golanty v. Commissioner, supra* at 427.

The record also reveals that petitioner received a substantial annual income from sources unrelated to the mining activity. Petitioner's ability to provide Vemco with continuous capital infusions was no doubt due to her substantial annual income. But for the existence of petitioner's substantial annual income, neither petitioner nor Vemco could have sustained the perennial losses generated by the mining activity. See section 1.183-2(b)(8), Income

Tax Regs.

Where a taxpayer procures, but fails to follow, the advice of experts, a lack of an objective to derive profit may be indicated unless it appears that the taxpayer is attempting to develop a different yet profitable technique. Section 1.183-2(b)(2), Income Tax Regs.

In their various reports, Weaver and Ehrlinger recommended that, in light of several factors including high transportation costs, a mill be installed at or near the site of the mine for a profitable and a more efficient operation overall. In fact, Ehrlinger's report contained only one profit projection which was based on an assumed operating rate of 50 tons per day. Ehrlinger's report also included blueprints and estimated costs for a 50 ton capacity mill. This report, in which profits were forecasted, contained the only detailed projection of income, expenses and profits found in the record before us.

Young testified that four tons per day was the maximum capacity of the mill that was actually employed in the mining operations and we find nothing in the record to indicate that a larger capacity mill was installed. It is apparent that Vemco's failure to implement Weaver's and Ehrlinger's recommendations for a larger capacity mill, which was the sole basis upon which we find profits were projected, severely hampered any chances of transforming the mining activity into a profitable operation.

Vemco maintained books and records. However, based on the record before us, including the testimony of Carpenter, it is clear that Vemco maintained incomplete books and records inasmuch as Carpenter was unable to verify many of Vemco's claimed payments by tracing them back to a source document. See section 1.183-2(b)(1),

Income Tax Regs.

We find it noteworthy that Young's testimony revealed that he has never operated a profitable mine. However, Weaver testified that, in the past, he operated profitable mines located in Utah and Colorado, but not in Mexico. See section 1.183-2(b)(5), Income Tax Regs.

Weaver also testified that he was in charge of the day-to-day operations at the mining claims from 1973 until 1976 when, although the record is unclear on this point, it appears that Young became in charge of operations. We are mindful of the testimony of both Weaver and Young that they contributed time and effort to the mining operations. See section 1.183-2(b)(3), Income Tax Regs.

However, we find that, based on the facts shown by the record in this case, neither Vemco nor petitioner could have had a bona fide objective or reasonable prospect of making a profit out of the mining venture. Very little marketable gold or silver was mined or recovered over a period of at least five years (1972-1978), and yet few or no steps were taken to increase the production. Money may have been spent to improve the transportation of the ore from the mine to the market but little was done to bring ore to the surface for transportation. And very little was spent to increase or improve the crushing, separation and cleaning process had the ore been mined. Under the circumstances we cannot find that petitioner or Vemco entertained an actual and honest objective of realizing a profit from the mining activities within the meaning of section 183(a). Based on the record we are at a loss to understand just what the objective of petitioner and Vemco was in throwing good money after bad into this project. We harbor a suspicion, however, that had petitioner not had a sizeable outside income and possibly no interest in spend-

ing her income in any other way, she would have taken a good hard look at the venture and would have been less willing to continue putting money into it just to keep it alive.

We recognize that gold mining is a risky business and also that if it is successful it will pay off well, and that some people are willing to take the risk for the anticipated reward. But where, as here, efforts had been made to mine this property for years, according to the evidence, without sufficient production to report any income from mining, it would be a pipe dream to expect to make a profit without some change in circumstances, and there is no evidence that changes were made that would materially increase production.

On balance we find that neither Vemco nor petitioner entertained an actual and honest objective of realizing a profit from this mining venture for the years involved within the meaning of section 183(a).

Moreover, to the extent that certain deductions claimed by petitioner, through Vemco, are not precluded by application of section 183, we nonetheless find that they are disallowed by virtue of their being the expenses of another taxpayer.

It is a well-established principle of Federal tax law that a shareholder is precluded from deducting the expenses of a corporation of which it is a shareholder because the corporation and its shareholders are recognized as separate taxable entities. *Deputy v. du Pont*, 308 U.S. 488 (1940). Although it is true that Vemco's activities went beyond the passive holding of stock in the Mexican corporation this, in itself, does not form a sufficient basis upon which we should disregard the corporate existence of the

Mexican corporations. *Rink v. Commissioner*, 51 T.C. 746, 752 (1969). The record before us reveals that the Mexican corporations had substance, that their existence was not a mere matter of form, and that they maintained a meaningful corporation/shareholder relationship with Vemco. Moreover, we have reviewed the character of the expenses which petitioner, through Vemco, claimed as deductions and find them to be those properly attributable to the Mexican corporations.

But petitioner contends, for the first time in her reply brief, that the corporate entity should be disregarded inasmuch as the substance of the relationship between the Mexican corporations and Vemco was that of a joint venture. A joint venture is treated and taxable as a partnership for tax purposes under section 761(a) and 7701(a)(2). See also section 1.761-1(a), Income Tax Regs.

In support of her joint venture contention, petitioner relies heavily upon *Commissioner v. Bollinger*, 485 U.S. 340 (1988). Generally, a corporation is regarded as a separate taxable entity even if it has only one shareholder who exercises total control over its affairs. *Moline Properties v. Commissioner*, 319 U.S. 436 (1943). But where a corporation is acting as the agent of its shareholder, the separate entities of corporation and shareholder may be disregarded for Federal tax purposes because the law attributes tax consequences of property held by a genuine agent to the principal. *Commissioner v. Bollinger, supra.* The three-part test to be used in determining whether a corporation is a true agent of its shareholder is (1) whether the fact that the corporation is acting as an agent with respect to a particular asset is set forth in a written agreement at the time the asset is acquired; (2) whether the corporation functions as agent and not as principal with respect to the asset for all purposes; and (3) whether the corporation is

held out as the agent and not as the principal in dealings with third parties relating to the asset. See *George v. Commissioner*, 844 F.2d 225, 228-229 (5th Cir. 1988), affg. a Memorandum Opinion of this Court.

After a review of the record before us, we find that petitioner has failed to satisfy each part of the three-part *Bollinger* test. Therefore, Vemco's relationship vis-a-vis each of the Mexican corporations was not one of principal/agent. Thus, the amounts are not deductible by petitioner, through Vemco, because as a shareholder Vemco is not entitled to pay and claim a deduction for expenditures properly attributable to the Mexican corporations. See *Koree v. Commissioner*, 40 T.C. 961, 965-966 (1963). Instead, we agree with respondeant's position that petitioner "is no doubt entitled [to] additional basis in her allocable share of the corporate stock attributable to the payment of" amounts that "*** were related to corporate business and deductible by the corporation ***"

In view of the foregoing, we find it unnecessary to address the remaining issues raised by the parties, save the inventory issue discussed below, because they are rendered moot.

Inventory Issue

Whether the application of section 482 reduces Vemco's (and petitioner's distributive share of) claimed inventory loss to zero for the taxable year 1976.

Section 482 allows respondent to allocate between any two or more controlled organizations, trades, or businesses, gross income, deductions, credits, or allowances if respondent determines that such allocation is necessary in order to prevent evasion of taxes or clearly to

reflect the income of any such organizations, trades, or businesses.

"Controlled" is defined in sweeping terms so as to include any type of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. Section 1.482-1(a)(3), Income Tax Regs. It is the reality of the control which is decisive, not its form or the mode of its exercise.

Petitioner owned a majority interest in both Cannon Aero and Vemco. Petitioner exerted financial control over each organization. Based on the record before us, it is abundantly clear that petitioner controlled both Cannon Aero and Vemco within the meaning of section 482.

In his notice of deficiency, respondent determined that a $12,600 date of acquisition fair market value should be allocated to the inventory assets. Petitioner has the burden of proving that respondent's determination is erroneous. *Welch v. Helvering, supra*; Rule 142(a). Therefore, in order to prevail petitioner must prove that either the date of acquisition fair market value of the inventory assets was more than $12,600 to justify a writedown in 1976 or that respondent's determination under section 482 was unreasonable, arbitrary, or capricious. *Ach v. Commissioner*, 42 T.C. 114, 126 (1964), affd. 358 F.2d 342 (6th Cir. 1966), cert. denied 385 U.S. 899 (1966).

Petitoner has conceded that the inventory became obsolete prior to the time petitioner transferred the inventory to Vemco. There is nothing in the record before us indicating that the inventory was worth more than $12,600 at the beginning of the year 1976. The inventory loss was properly disallowed inasmuch as any allowable loss that might have been claimed was properly that of Cannon Aero

and not that of Vemco. Petitioner has clearly failed to carry her burden of proof, and therefore, respondent's disallowance of petitioner's claimed cost of goods sold in the amount of $42,250 must be sustained.

Decision will be entered for the respondent.

Internal Revenue Service Department of the Treasury
Regional Commissioner

Date: 9 FEB 1982 Tax Year Ended and Deficiency:
12-31-76 $136,531.00
12-31-77 $245,576.00

Mrs. Charla Gates Cannon
420 South Marion Parkway, #2002
Denver, Colorado, 80209

Person to Contact
Ronald J. Dombroyski

Certified Mail #367801

Contact Telephone Number
713/226-4604

Dear Mrs. Cannon:

We have determined that there is deficiency (increase) in your income tax as shown above. This letter is a NOTICE OF DEFICIENCY sent to you as required by law. The enclosed statement shows how we figured the deficiency.

If you want to contest this determination in court before making any payment, you have 90 days from the above mailing date of this letter (150 days if addressed to you outside of the United States) to file a petition with the United States Tax Court for a redetermination of the amount of your tax. The petition should be filed with the United States Tax Court, 400 Second Street NW., Washington, DC 20217 and the copy of this letter should be attached to the petition. The time in which you must file a petition with the Court (90 or 150 days as the case may be) is fixed by law and *the Court cannot consider your case if your petition is filed late.* If this letter is addressed to

both a husband and wife, and both want to petition the Tax Court, *both* must sign the petition or each must file a separate, signed petition. You can get a copy of the rules for filing a petition by writing to the Clerk of the United States Tax Court, at the address shown in this paragraph

If you decide not to file a petition with the Tax Court, we would appreciate it if you would sign and return the enclosed waiver form. This will permit us to charge your account quickly and will limit the accumulation of interest. The enclosed addressed envelope is for your convenience. If you decide not to sign and return the waiver and you do not timely petitiion the Tax Court, the law requires us to bill you after 90 days from the above mailing date of this letter (150 days if this letter is addressed to you outside the United States).

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely yours.

Roscoe L. Egger, Jr.
Commissioner
By /s/ Vincent A. Imbornone
Vincent A. Imbornone
Associate Chief, Appeals Office
Houston Letter 894(RO)(Rev.8)

Enclosures:
Copy of this letter
Statement
Waiver
Envelope

Room 8031, 515 Rusk Ave., Houston, Texas 77002

COPY

UNITED STATES TAX COURT

CHARLA GATES CANNON,	)	
	)	
Petitioner,	)	
	)	
	)	Docket No.
	)	9671-82
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed March 20, 1990, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years 1976 and 1977 in the amounts of $155,221.20 and $244,581.83, respectively.

(Signed) W.M. DRENNEN

Judge

Entered: JUL 10 1990

COPY

UNITED STATES TAX COURT

CHARLA GATES CANNON,	)	
	)	
Petitioner,	)	
	)	
	)	Docket No.
	)	2261-85
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed March 20, 1990, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years 1978 and 1979 in the amounts of $120,334.60 and $101,980.00, respectively.

(Signed) W.M. DRENNEN

Judge

Entered: JUL 10 1990

APPENDIX D

PUBLISH

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

FILED
NOV 15 1991

CHARLA GATES CANNON,	)	
	)	
Petitioner-Appellant,	)	
	)	
	)	Docket No.
	)	90-9017
	)	
v.	)	
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
	)	
Respondent-Appellee.	)	

Appeal from the United States Tax Court
No. 9671-82

Towner Leeper of Leeper & Leeper, El Paso, Texas (Arthur Bosworth of Denver, Colorado with him on the brief) for Petitioner-Appellant.

Sally J. Schornstheimer of the United States Department of Justice, Tax Division, Washington, D.C. (Gary R. Allen,

Richard Farber, and Shirley D. Peterson with her on the brief) for Respondent-Appellee.

Before **MOORE** and **EBEL**, Circuit Judges, and **ANDERSON**, District Judge*.

EBEL, Circuit Judge.

This case concerns a taxpayer who became involved in an unprofitable mining venture and deducted her distributive share of certain partnership losses on her income tax returns. The Commissioner of Internal Revenue disallowed these deductions, and the Tax Court upheld the Commissioner's determinations. The taxpayer appeals, raising two issues. First, did the Tax Court correctly resolve the case on a theory not considered by either party, namely, section 183 losses? Second, did the Tax Court correctly conclude that the limited partnership did not incur the expenses at issue with the requisite profit motive? We conclude that the Tax Court's reliance on section 183 was proper and that the court's findings regarding partnership motives were not clearly erroneous. Accordingly, we affirm.

I. BACKGROUND

The facts in this case are fully set forth in the Tax Court's opinion. *See Cannon v. Commissioner,* 59 T.C.M. (CCH) 164 (1990). For purposes of this appeal, they may be summarized as follows:

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* The Honorable Aldon J. Anderson, District Judge, United States District Court for the District of Utah, sitting by designation.

This case involves a taxpayer's treatment of losses incurred in connection with a Mexican gold and silver mining venture. In 1973, the taxpayer, Charla Cannon, joined a limited partnership ("Vemco") that was formed "to engage in the business of land development, exploration, mining and ore processing both in the United States and foreign countries." *Id.* at 165 (citation omitted). The taxpayer, who had a large annual income from trusts and her deceased husband's estate and employment benefits, provided Vemco with the funds necessary to conduct its business operations. In return, she was to receive a higher percentage than her partners of the profits or the proceeds in the event of a sale or disposition of the partnership assets. In addition, the annual expenses and losses of the partnership were allocated to the taxpayer insofar as her capital account permitted.

Vemco decided to invest in the Mexican venture at issue in this case in reliance upon the findings of an experienced miner who explored the sites and an engineer who analyzed and reported on the mining properties. Because Mexican law prohibits non-Mexican nationals or corporations from acquiring a majority interest in Mexican mining concessions, Compania Minera San Jose de Manzanillas, S.A. ("Manzanillas"), a Mexican corporation, held the mining concessions, and Vemco became a forty-nine percent shareholder in that corporation.[1] In 1978, however, Vemco discovered that the president of Manzanillas had been embezzling, and the mining concessions were transferred to Memco, a different Mexican corporation. Although the taxpayer, through Vemco, expended over $800,000 for exploration and development of the mines, Memco never operated at a profit. Vemco did not

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[1] The taxpayer claimed that Vemco was in a joint venture with this Mexican corporation, but the Tax Court rejected this argument. 59 T.C.M. at 171.

report any income from mining for the years involved in this lawsuit, nor did it receive any dividends.

The taxpayer deducted her distributive share of the partnership losses claimed by Vemco on her federal income tax returns for 1976, 1977, 1978, and 1979. The Commissioner of internal Revenue ("Commissioner") disallowed these deductions on the grounds that the taxpayer did not establish that these amounts constituted ordinary and necessary business expenses or were for an activity entered into for profit or for the production of income. Alternatively, the Commissioner asserted that these amounts were nondeductible capital contributions to the Mexican corporation that the parties formed to hold title to the mines.

The Tax Court agreed with the Commissioner's decision to disallow the deductions, but found the expenditures to be nondeductible under section 183 of the Internal Revenue Code. Because the Tax Court decided the case on the basis of a section that neither party raised explicitly, the taxpayer filed a motion for reconsideration, which was denied. The taxpayer appeals. This court has jurisdiction to review the Tax Court's decision pursuant to 26 U.S.C. § 7482(a).

We first discuss whether the Tax Court erred in resolving this case on the basis of section 183. We then discuss whether the expenses at issue were incurred with the requisite profit motive.

II. DISCUSSION

A. *The Propriety of Resolving the Case Under Section 183*

In *Commissioner v. Transport Manufacturing &*

Equipment Co., 478 F.2d 731, 735 (8th Cir. 1973), the Eighth Circuit stated that the Commissioner should notify the taxpayer of the particular Code section, regulation, or theory involved in a case to avoid prejudice to the taxpayer. The court reasoned that "[t]he taxpayer works at an extreme disadvantage in trying to invalidate deficiency assessments if he does not specifically know why the Commissioner is challenging the taxpayer." *Id.* (footnote omitted). The court recognized, however, that prejudice does not always result: "Of course, if a certain Code section, regulation or theory has not been specifically raised in the notice of deficiency, in the pleadings, or at trial and if there is an absence of surprise on the taxpayer's part, the taxpayer has no reason to complain." *Id.* n.8 (citation omitted).

Here, the taxpayer contends that the Tax Court erroneously decided this case on the basis of a theory and Code provision (lack of profit motive and section 183) that neither party considered or raised, thereby surprising and prejudicing the taxpayer. According to the taxpayer, only three Code sections were at issue: sections 162, 212, and 616.[2] We disagree. Section 183 is interrelated to sections 162 and 212, profit motive being the common underlying theme. Indeed, as discussed *infra*, these provisions even reference each other. Accordingly, we find that the tax-

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[2] Section 162 allows for the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." I.R.C. § 162(a).

Section 212 allows for the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year — (1) for the production or collection of income; [or] (2) for the management, conservation, or maintenance of property held for the production of income . . . ." I.R.C. § 212.

Section 616 allows for the deduction of development expenditures for mines and other natural deposits "if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed." I.R.C. § 616(a).

payer in this case was adequately put on notice, was not prejudiced, and should not have been surprised.

The taxpayer asserts that neither party ever considered the Tax Court's position that a profit motive was not present. Yet, the evidence reveals that profit motive was indeed a critical issue in this case and that the Commissioner was unwilling to concede the presence of a profit motive. For example, the statutory notices of deficiency that the Commissioner issued to the Taxpayer expressly stated that she had not established that she entered into the transaction in pursuit of economic profit and that this lack of profit motive was one of the bases for the disallowance of the claimed partnership deductions. Record, vol. I, doc. 3, Deficiency Notice, Explanation of Adjustments, Exhibit A. In addition, the Commissioner's opening statement explicitly noted that the taxpayer had to prove a profit motive. Record, vol. II, Transcript, Nov. 19, 1986, at 26. Indeed, the taxpayer attempted to do this, *see infra* Part II.B, and acknowledged that "[t]o obtain a deduction under Section 162 for a trade or business expense or under Section 212 for an expenditure for the production of income requires a profit motive." Brief for Appellant at 37.[3]

In determining whether the mining activity met the requirements of sections 162 or 212, the court naturally applied section 183. Section 183 is often used in analyzing "for profit" issues, both in the context of hobby losses and in the context of trade or business expenses. Numerous courts have used the regulations accompanying section 183 to determine profit motive under other sections. *See, e.g., Independent Elec. Supply, Inc. v. Commissioner,* 781 F.2d

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[3] *Thomas v. Commissioner,* 792 F.2d 1256, 1259 (4th Cir. 1986), establishes that section 616 also requires a profit motive.

724, 726-27 (9th Cir. 1986) ("the courts have relied on the section 183 factors in conducting the profit motive analysis under section 162"); *Brannen v. Commissioner,* 722 F.2d 695, 704-06 (11th Cir. 1984) (applying factors listed in section 183 regulations to determine whether taxpayer's activities were engaged in for profit under section 162); *Faulconer v. Commissioner,* 748 F.2d 890, 893 (4th Cir. 1984) (referring to section 183 to determine whether a taxpayer was entitled to deductions under sections 162 or 212, noting that the profit motive is the same under all three statutory sections, and concluding that "[t]he regulations under section 183, therefore, explicate the profit-motive requirements of sections 162 and 212"); *Carter v. Commissioner,* 645 F.2d 784, 786 (9th Cir. 1981) ("[section] 183(c) must be read in conjnunction with [section] 162") (footnote omitted); *Dreicer v. Commissioner,* 665 F.2d 1292, 1294 (D.C. Cir. 1981) ("a taxpayer claiming a deduction under Sections 162 or 212 for an expense, or under Section 165 for a loss, must be prepared to demonstrate an associated profit motive in order to avoid the ban of Section 183") (footnote omitted). Thus, the Tax Court's application of section 183 was routine and predictable, not extraordinary.

In fact, the regulations accompanying section 212, on which the taxpayer relied, expressly refer to section 183. They specify that the inquiry as to profit motive under section 212 is determined by reference to section 183 and the accompanying regulations: "For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder." Treas. Reg. § 1.212-1(c). Section 183 similarly references sections 162 and 212 when it defines "activity not engaged in for profit" as "any activity other than one with respect to which deductions are allowable . . . under section 162 or under paragraph (1) or

(2) of section 212." I.R.C. § 183(c).

In summary, the tax Court did not err in resolving this case on the basis of Internal Revenue Code section 183. Given the importance of profit motive, the Tax court's reliance on section 183 was both predictable and nonprejudicial.

B. *Applying Section 183*

Having determined that it was proper to utilize section 183 in this case, we next address whether the Tax Court correctly applied the factors enumerated in the Treasury Regulations accompanying that section.

Whether Vemco and the taxpayer were in pursuit of economic profit is a question of fact. The applicable standard of review is a stringent one: a finding of fact should not be disturbed unless it is clearly erroneous. Fed. R. Civ. P. 52(a). "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with a definite and firm conviction that a mistake has been committed." *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948).

The taxpayer makes a persuasive argument that might well have convinced us if we were examining the record de novo. However, as the Supreme Court stated in *Anderson v. Bessemer City*, 470 U.S. 564 (1985):

> This [clearly erroneous] standard plaintly does not entitle a reviewing court to reverse the finding of the trier of fact simply because it is convinced that it would have decided the case differently. . . . If the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that

> had it been sitting as the trier of fact, it would have weighed the evidence differently.

Id. at 573-74. Given the Tax Court's "plausible" account of the evidence, we cannot say as a reviewing court that its decision was clearly erroneous. After a thorough examination of the facts and circumstances of this case, we therefore affirm the Tax Court's determination that neither the taxpayer nor Vemco possessed the requisite profit motive.

The Tax Court appropriately delineated the proper procedures to follow in determining whether an activity is engaged in for profit. Where a partnership is involved, as it is in this case, the dominant economic motive of the partnership, not that of the individual investors, is determinative. *Polakof v. Commissioner,* 820 F.2d 321, 323 (9th Cir. 1987), *cert. denied,* 484 U.S. 1025 (1988); *Tallal v. Commissioner,* 778 F.2d 275, 276 (5th Cir. 1985); *Brannen,* 722 F.2d at 703-04.

The taxpayer bears the burden of proving the required profit objective. Tax Ct. R. 142(a); *Welch v. Helvering,* 290 U.S. 111, 115 (1933). The test is whether profit was the dominant or primary objective of the venture. *See, e.g., Polakof,* 820 F.2d at 323-24 ("dominant economic motive." "primary purpose"); *Thomas v. Commissioner,* 792 F.2d 1256, 1259 (4th Cir. 1986) ("primary objective"); *Snyder v. United States,* 674 F.2d 1359, 1364 (10th Cir. 1982) ("primarily motivated"); *Eastman v. United States,* 635 F.2d 833, 837 (Ct. Cl. 1980) ("primary purpose, " "overriding profit motivation").

The regulations under section 183 set forth nine nonexclusive factors to be considered in determining whether a taxpayer's activities are engaged in with the ob-

jective of realizing a profit: (1) the extent to which the taxpayer carries on the activity in a businesslike manner; (2) the taxpayer's expertise or his reliance on the advice of experts; (3) the time and effort the taxpayer expends in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the taxpayer's success in similar activities; (6) the taxpayer's history of income or loss in the activity; (7) the amount of occasional profits, if any; (8) the taxpayer's financial status; and (9) the elements of personal pleasure or recreation. Treas. Reg. § 1.183-2(b).

The Treasury Regulations provide insight regarding how to apply these objective factors to determine subjective intent. The ultimate inquiry entails examining the facts and circumstances of each case:

> No one factor is determinative in making this determination. In Addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa.

Id.

The Tax Court applied the relevant factors and concluded that the partnership was not motivated by profit on the following bases: (1) the $50,172.32 projected net monthly profit that lured the taxpayer and Vemco into this mining activity, predicted in the expert's report, was unattainable as it was erroneously based upon projected ore grades that were contrary to actual test results. (2) Vemco failed to increase the milling capacity of the mines as

recommended in the same expert report.[4] (3) Vemco continued to fund projects relating to the mines even though they had an unbroken record of substantial losses ($2,205,045.10), they were unlikely to recoup those losses, and the Mexican corporations never paid a dividend to Vemco. (4) Despite these losses, Vemco took few steps to increase production. (5) The taxpayer received substantial income from other sources, which enabled her to provide large amounts of capital.[5] (6) Vemco maintained incomplete books and records.

In support of the taxpayer's position, the Tax Court acknowledged that some of the limited partners contributed time and effort to the mining operations[6] and that one limited partner had operated profitable mines in the past.[7] We add several other factors to this short list, namely the taxpayer's repeated statements regarding profit motive during the proceedings below, the taxpayer's reliance upon expert advice, and the lack of an alternative non-profit-making explanation for the venture.

The taxpayer stated during the proceedings before

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[4] Treas. Reg. § 1.183-2(b)(2) provides: "Where a taxpayer . . . procures . . . expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity."

[5] Although we agree with the Tax Court's assessment of the other Treasury Regulation factors, we find the factor focusing upon the financial status of the taxpayer to be a wash. *See* Treas. Reg. § 1.183-2(b)(8).

[6] *See* Treas. Reg. § 1.183-2(b)(3).

[7] *See* Treas. Reg. § 1.183-2(b)(5). The taxpayer's own previous businesses included a profitable aeronautical business, an unprofitable sheep-raising operation, a profitable woman's exercise and health spa, and a helicopter sales business for which success or lack of success was not established. Record, vol. II, Transcript, Nov. 20, 1986, at 297-300.

the Tax Court that she was indeed motivated by a desire to profit:

> Counsel: What was your motive in — why did you want to spend — make an investment down there? do you enjoy mining?
>
> Cannon: Well, I had heard a great deal about mining all my life, but also, over and above that, I obviously was down there to make money.
>
> . . .
>
> I have invested in several things throughout my lifetime and this one looked very good . . . .
>
> . . .
>
> I had no intention to do anything except make money.

Record, vol. II, Transcript, Nov. 20, 1986, at 289-90. She also discussed the profitability of her former ventures and the anticipated profits of this venture. *Id.* at 285, 293, 296-300.[8]

Vemco's solicitation of expert advice further supports the taxpayer's contention that the mining activity was engaged in for profit. *See* Treas. Reg. § 1.183-2(b)(2). Carl Weaver, an experienced miner since 1939 in Arizona, Colorado, Utah, and Mexico and a limited partner in Vemco, explored the mines and prepared a report on their histories and capabilities. Henry Ehrlinger, a professor of mining and engineering at the university of Texas at El Paso, also analyzed and reported on the mines. Ehrlinger

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[8] We note, however, that a taxpayer's statement of intent is given less weight than objective factors in determining such intent. Treas. Reg. § 1.183-2(a); *Engdahl v. Commissioner*, 72 T.C. 659, 666 (1979); *see also Brodrick v. Derby*, 236 F.2d 35, 38 (10th Cir. 1956) (circumstances may indicate motive contrary to that stated).

had considerable experience in Mexican mining and had operated a company similar to Vemco on his own. Ralph Wilcox, Jr., a graduate geology student at the University of Texas, analyzed ore samples taken from the mines. The taxpayer relied upon this expertise. Record, vol. 2, Transcript, Nov. 20, 1986, at 283-89.

Finally, the ninth factor, "Elements of personal pleasure or recreation," deserves more attention than it was given by the Tax Court. Treas. Reg. § 1.183-2(b)(9) clearly indicates that "a profit motivation may be indicated where an activity lacks any appeal other than profit." Here, the absence of any suggestion of an alternative motive in the record is a powerful factor in support of the taxpayer's position.[9]

Although it is unclear what besides profit might have prompted Vemco to expend substantial amounts of money on this venture, we cannot declare the court's finding clearly erroneous. The Tax Court carefully applied the appropriate factors and provided a solid basis for its decision.

With respect to the experts' reports, the Tax Court

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[9] Courts that fail to discern a profit motive often specify an alternative explanation for a party's actions. *See, e.g., Polakof,* 820 F.2d at 324 (limited partnership that bought film properties was motivated by a desire to create tax shelters rather than to profit); *Thomas,* 792 F.2d at 1258 (primary objective of coal mining program was to secure tax benefits rather than to earn an economic profit); *Estate of Power v. Commissioner,* 736 F.2d 826, 831 (1st Cir. 1984) (taxpayer's horse-breeding activity was engaged in for personal satisfaction, not profit); *Eastman,* 635 F.2d at 841 (family engaged in horse-breeding in order to utilize the losses from that operation to offset other income). *But see Antonides v. Commissioner,* 893 F.2d 656, 660 (4th Cir. 1990) (suggesting that the court does not need to pinpoint the likely motivation, as long as it determines on the basis of the Treasury Regulation factors that the activity was not engaged in for profit).

emphasized that Ehrlinger's monthly profit projection of $50,172.32 was erroneously based upon inconsistent data regarding the ore grades that could be realized per ton of ore mined. 59 T.C.M. at 169. The actual assay work on the ore veins showed a decidedly poorer ore body in general than was assumed in the expert's report. *Id.* In addition, Vemco did not implement the critical aspects of the experts' advice, upon which any prospect of profits depended. *Id.* at 170. *See* Treas. Reg. § 1.183-2(b)(2) (where a taxpayer procures but does not follow expert advice, "a lack of intent to derive profit may be indicated"). Specifically, Weaver and Ehrlinger recommended that Vemco install a higher capacity mill in order to enhance the efficiency and profitability of the mines; indeed, their profit projections depended upon this mill. Vemco never installed it, however, thereby preclusing any chances of transforming this mining venture into a profitable operation. 59 T.C.M. at 170.

The Tax Court also emphasized that Vemco did not receive any profits from this mining venture for an entire eleven-year-period. In fact, the mines had an unbroken record of substantial losses totalling $2,205,045.10. *Id.* at 169. A record of such persistent and substantial losses is persuasive evidence that Vemco did not possess the requisite profit motive. *See* Treas. Reg. § 1.183-2(b)(6) ("[W]here losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, . . . may be indicative that the activity is not being engaged in for profit."). Furthermore, Vemco took few steps to increase production in the face of these overwhelming losses, and the record reveals that Vemco was unlikely to recoup the losses.

Finally, Vemco maintained incomplete books and records, as it was unable to verify many claimed

payments by tracing them back to a source document. *See* Treas. Reg. § 1.183-(2)(b)(1).

In summary, the record reveals that several of the factors set forth in Treas. Reg. § 1.183-2(b) support the taxpayer's position, whereas others support the government's position. Taking all facts and circumstances into account, we cannot say that the Tax Court's application of the Treasury Regulations accompanying section 183 was clearly erroneous. Accordingly, we AFFIRM the findings of the Tax Court.

In light of this ruling, we need not address the alternative basis that the Tax Court provided for its decision, namely that the deductions that the petitioner claimed through Vemco "are disallowed by virtue of their being the expenses of another taxpayer." 59 T.C.M. at 170.

AFFIRMED.

APPENDIX E

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

CHARLA GATES CANNON,	)	
	)	
Petitioner - Appellant,	)	
	)	
	)	
v.	)	No.90-9017
	)	
COMMISSIONER OF IN-TERNAL REVENUE,	)	
	)	
	)	
Respondent - Appellee.	)	

ORDER
Filed January 13, 1992

Before MOORE and EBEL, Circuit Judges, and ANDERSON, District Judge.*

This matter comes on for consideration of petitioner-appellant's petition for rehearing filed December 16, 1991.

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* Honorable Aldon J. Anderson, District Judge, United States District Court for the District of Utah, sitting by designation.

Upon consideration thereof, the petition is denied.

Entered for the Court

Robert L. Hoecker, Clerk

By /s/ Partrick Fisher

Patrick Fisher
Chief Deputy Clerk

exchange tax-free property of a like-kind.

General reasons for change.—One aspect of the farm loss problem called to the committee's attention does not involve a practice permitted by present law, but rather involves an erroneous interpretation of the like-kind exchange rule of present law. It appears this rule has been incorrectly represented by some persons who promote tax-motivated livestock purchases. There appear to have been representations that male calves can be traded for female calves tax free as a like-kind exchange. The importance of this arises from the fact that ordinarily the ratio of males to females in a calf crop is approximately 50-50. Since few males are normally retained in a typical cattle operation, the remaining male calves are castrated and sold as steers at ordinary income rates. If a tax-free trade of male calves for female calves were allowed, a breeding herd of females could be built up more quickly without tax consequences.

The committee understands that the Revenue Service does not consider this to be a like-kind exchange (although it has no published position). The House Ways and Means Committee in its report on this bill noted this problem and indicated it believed that Congress did not intend this type of exchange to be considered as a like-kind exchange. It also stated its belief that allowing this treatment would be an incorrect interpretation of the statute.

The committee agrees with the House that this type of exchange should not be considered a like-kind Exchange. When male calves are exchanged for female calves, the exchange does not involve like-kind property since the male animals are not held for breeding purposes and, in fact, are

not of a "like-kind" with females. The committee believes, however, that it would be more appropriate to specifically deal with this matter in the bill.

Explanation of provision.—For the above reasons, the committee amendments provide that, for purposes of applying the tax-free, like-kind exchange rule of present law, livestock of different sexes are not property of a like-kind.

Effective date.—Since this provision is merely declaratory of what Congress intended in present law, it is to apply with respect to taxable years to which the Internal Revenue Code of 1954 applies.

5. Hobby Losses (sec. 213 of the bill and secs. 183 and 270 of the code)

Present law.—Present law contains a so-called "hobby loss" provision (section 270) which limits to $50,000 per year the amount of losses from a trade or business carried on by an individual that can be used to offset other income. This limitation only applies, however, where the losses from the business exceed $50,000 per year for a period of at least 5 consecutive years. In computing the amount of a loss for purposes of this provision, certain specially treated deductions are disregarded. These deductions are taxes, interest, casualty, and abandonment losses connected with a trade or business, farm drought losses, net operating loss carryovers, and expenditures which may either be capitalized or currently deducted.

[103] *General reasons for change.*—The hobby loss provision generally has been of very limited application. It is often possible for a taxpayer to slightly rearrange his income and deductions so as to break the required string of

5 years. In addition, the exclusion of certain specially treated deductions from the loss computations means that a number of expenses are not considered to give rise to a loss even though they are in fact deducted. Moreover, in the few cases in which the hobby loss provision has applied so as to disallow the deduction of the loss, the taxpayer has been faced in 1 year with a combined additional tax attributable to a 5-year period.

In addition to the hobby loss provision, some court cases have provided another basis on which the loss can be denied; namely, that the activity carried on by the taxpayer from which the loss results is not a business but is merely a hobby. The committee agrees with the House that this basic principle provides a more effective and reasonable basis for distinguishing situations where taxpayers are not carrying on a business to realize a profit, but rather are merely attempting to utilize the losses from the operation to offset their other income.

The House bill replaced the present hoppy loss provision with a rule which provided that a taxpayer (individual or corporate) could not deduct losses arising from an activity carried on by him if the activity was carried on without a reasonable expectation of realizing a profit from it. Where the losses from an activity were more than $25,000 in three out of five consecutive years, then the activity would have been presumed to have been carried on without the requisite expectation of profit unless it was shown to the contrary by the taxpayer.

As previously indicated, the committee is in basic agreement with the approach taken by the House to the hobby loss problem. The committee is concerned, however, that requiring a taxpayer to have a "reasonable expectation" of profit may cause losses to be disallowed in situa-

tions where an activity is being carried on as a business rather than as a hobby. Accordingly, the committee has modied the House bill to provide that in determining whether losses from an activity are to be allowed, the focus is to be on whether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit. This will prevent the rule from being applicable to situations where many would consider that it is not reasonable to expect an activity to result in a profit even though the evidence available indicates that the activity actually is engaged in for profit. For example, it might be argued that these was not a "reasonable" expectation of profit in the case of a bona fide inventor or a person who invests in a wildacat oil well. A similar argument might be made in a case of a poor person engaged in what appears to be an inefficient farming operation. The committee does not believe that this provision should apply to these situations or that the House intended it to do so apply, if the activity actually is engaged in for profit.

Concern also has been expressed as to whether there would be a reasonable administration of this new provision. In view of this, the committee believes that the Treasury Department should establish two advisory groups down from the cattle and horse industries (one concerned with the cattle industry and one with the horse industry) to assist the Commissioner of Internal Revenue in establishing standards for the application of these rules to achieve reasonable results and to resolve policy questions in their application from time to time. This action should help limit *the* disallowance by the Internal Revenue [104]. Service of the deduction of losses under this provision to cases where it is generally recognized that this is appropriate. The Treasury Department has indicated its willingness to establish advisory groups of this nature.

Explanation of provision.—The committee amendments provide in general that an individual (or a subchapter S corporation) is not to be allowed to deduct losses (to the extent attributable to business deductions) arising from an activity which is not engaged in for profit. The committee amendments do not apply to corporate taxpayers (other than shareholders of subchapter S corporations), as did the House bill, since it is primarily in the case of individual taxpayers that the problem arises of a taxpayer entering into an activity to obtain a loss from the activity which is used to offset other income. In addition, the application of the provision to corporations would present a number of difficulties, such as its effect on shared facilities provided on a cost basis. No inference should be drawn from this action in the case of a corporation, however, as to whether or not any activity of the corporation is a business, or is engaged in for profit, for purposes of the tax laws.

The committee amendments provide that an activity is not engaged in for profit if deductions with respect to the activity not allowable as trade or business expenses or as expenses incurred for the production of income or in connection with property held for the production of income. In making the determination of whether an activity is not engaged in for profit, the committee intends that an objective rather than a subjective approach is to be employed. Thus, although a reasonable expectation of profit is not to be required, the facts and circumstances (without regard to the taxpayer's subjective intent) would have to indicate that the taxpayer entered the activity, or continued the activity, with the objective of making a profit. As previously indicated, a taxpayer who engaged in an activity in which there was a small chance of a large profit, such as a person who invested in a wildcat oil well or an inventor could qualify under this test even though the expectation of pro-

fit might be considered unreasonable.

Where an activity is not engaged in for profit, this provision specifically provides that a deduction is to be allowed for items which may be deducted without regard to whether they are incurred in a trade or business or for the production of income. This would include the deductions allowed for interest and state and local property taxes, and the long-term capital gains deduction. It is further provided that, in the case of an activity not engaged in for profit, a deduction is nevertheless to be allowed for the trade or business or production in income items which could be deducted if the activity were engaged in for profit, but only to the extent these items do not exceed the amount off gross income derived from the activity reduced by the deductions which are allowed in any event such as interest and certain state and local taxes. The deductions of this type which are to be allowed first (but after taxes, etc.) are those such as depreciation which involve basis adjustments.

Under the committee amendments a taxpayer is to be presumed to be engaged in an activity for profit for a taxable year, unless established to the contrary by the Secretary of the Treasury or his delegate, if in two or more years of the period of five consecutive taxable years ending with the current taxable year, the activity was carried on at a profit (i.e., if the gross income from the activity exceeds the deductions [105] attributable to the activity which would be allowed if it were engaged in for profit). For purposes of this presumption, all deductions attributable to the activity other than that allowed for net operating loss carryovers are to be taken into account.

Effective date.—This provision generally is to be effective with respect to taxable years beginning after

December 31, 1969. For purposes of applying the presumption, however, this provision also is to be applicable to prior taxable years.

6. Gain From Disposition of Farm Land (sec. 214 of the bill and sec. 1251 of the code)

Present Law.—Present law allows a taxpayer engaged in the farming

(2)

No. 91-1655

In the Supreme Court of the United States

OCTOBER TERM, 1991

CHARLA GATES CANNON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the Tax Court properly looked to the provisions of Section 183 of the Internal Revenue Code, 26 U.S.C. 183, in determining the allowability of mining expense deductions claimed by the partnership in which petitioner was a partner.

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In the Supreme Court of the United States

OCTOBER TERM, 1991

No. 91-1665

CHARLA GATES CANNON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A34-A48) is reported at 949 F.2d 345. The memorandum opinion of the Tax Court (Pet. App. A5-A29) is unofficially reported at 59 T.C.M. (CCH) 164.

JURISDICTION

The judgment of the court of appeals was entered on November 15, 1991. The petition for rehearing was denied on January 13, 1992 (Pet. App. A49-A50). The petition for a writ of certiorari was filed on April 13, 1992 (a Monday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1973, petitioner acquired an interest in a limited partnership (VEMCO), which decided to finance a Mexican gold and silver mining venture to be conducted by third parties. Petitioner provided VEMCO with the funds needed to finance the mining operations. Petitioner was to receive a higher percentage of VEMCO's profits or proceeds than her partners, and the partnership's annual expenses and losses were allocated to petitioner to the extent that her capital account permitted (Pet. App. A36). During the four years involved in this case, VEMCO received no income from its investment in the mining venture (*id.* at A36-A37).

Petitioner deducted her distributive share of the partnership losses on her federal income tax returns for 1976, 1977, 1978, and 1979. The Commissioner disallowed these deductions because petitioner had not established that these amounts were ordinary and necessary business expenses or were expended for an activity entered into for profit or for the production of income (Pet. App. A37).

2. Petitioner sought a redetermination in the Tax Court of the deficiencies asserted against her, contending that the expenses were deductible under Sections 162, 165, 212, 616, or 617 of the Internal Revenue Code (Pet. App. A17-A18). At trial, the Commissioner reiterated his position that petitioner had the burden of proving that the expenses for which VEMCO claimed deductions were incurred for the purpose of realizing an economic profit. Petitioner introduced evidence in an attempt to meet that burden, including her own testimony regarding her desire to "make money" and the profitability of other business ventures in which she had engaged. She also

sought to rely on an expert's report containing profit projections that had been prepared for VEMCO.[1]

The Tax Court found that VEMCO had not engaged in the mining activities with a bona fide profit objective. The court therefore concluded that petitioner was not entitled to deduct the claimed losses (Pet. App. A19-A21).[2] Although neither party had made reference to Section 183 of the Internal Revenue Code in their briefs to the Tax Court, the court cited Section 183(c), entitled "ACTIVITIES NOT ENGAGED IN FOR PROFIT DEFINED," and considered the factors enumerated in Treas. Reg. § 1.183-2(b) in determining that the mining activity was not one engaged in for profit (Pet. App. A19-A24).

3. Petitioner sought reconsideration by the Tax Court of its decision, arguing that she was unfairly surprised and prejudiced by the court's application of Section 183 and the factors listed in Treas. Reg. § 1.183-2(b). The Tax Court denied her motion.

The court of appeals affirmed. The court concluded "that the Tax Court's reliance on section 183 was proper and that the court's findings regarding partnership motives were not clearly erroneous" (Pet. App. A35).

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[1] The parties also introduced evidence regarding other grounds advanced by the Commissioner for disallowance of the partnership's deductions, including whether the expenses were development expenses under Section 616, capital contributions to Mexican corporations in which VEMCO was a shareholder, or the expenses of the Mexican corporations rather than of VEMCO (Pet. App. A7, A25-A27).

[2] The court first concluded that petitioner was not entitled to deduct the expenses under Sections 162 and 165 of the Code because neither she nor VEMCO was directly engaged in the business of mining in Mexico (Pet. App. A18-A19).

ARGUMENT

The court of appeals correctly held that the Tax Court properly considered Section 183 of the Code and the factors enumerated in Treas. Reg. § 1.183-2(b) in determining whether VEMCO entered into the mining activity that generated the losses in question with the objective of making a profit. The decision of the court of appeals does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. Section 183(a) of the Code provides, as a general rule, that no deduction attributable to any activity shall be allowed if the activity is not engaged in for profit. See 26 U.S.C. 183(a). The term "activity not engaged in for profit" is defined in Section 183(c) as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212." 26 U.S.C. 183(c). Contrary to petitioner's contention (Pet. 4-5), Section 183 is inherently interrelated with Sections 162 and 212, for it defines the critical term "activity not engaged in for profit" by reference to deductions permitted under those two provisions. See Pet. App. A38.

Section 162 permits the deduction of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. 26 U.S.C. 162. To be engaged in a trade or business, "the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987). See also *Thomas* v. *Commissioner*, 792 F.2d 1256, 1259 (4th Cir. 1986). Section 212 allows the deduction of ordinary and necessary expenses paid or incurred in the production or collection of income or in the management, conservation, or maintenance of property held for the production of income. 26 U.S.C. 212. As un-

der Section 162, a deduction is available under Section 212 only for activities or transactions entered into primarily for profit. See, *e.g.*, *Wrightsman* v. *United States*, 428 F.2d 1316, 1320 (Ct. Cl. 1970); *Carkhuff* v. *Commissioner*, 425 F.2d 1400, 1404 (6th Cir. 1970).

The Commissioner disallowed the deductions claimed by VEMCO on the ground that petitioner had failed to establish that VEMCO's activities were engaged in primarily for profit (Pet. App. A37). It was therefore petitioner's burden to demonstrate that the requisite profit motive existed. *Independent Electric Supply, Inc.* v. *Commissioner*, 781 F.2d 724 (9th Cir. 1986); *Dreicer* v. *Commissioner*, 665 F.2d 1292 (D.C. Cir. 1981). In determining whether petitioner had met her burden of proof, the Tax Court considered the factors set forth in the regulations promulgated under Section 183 (Treas. Reg. § 1.183-2(b)).[3] In doing so, the court acted in accordance with a long line of appellate authority.[4] *Antonides* v. *Commissioner*, 893 F.2d 656, 659 (4th Cir. 1990) (the "profit

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[3] Treasury Regulations § 1.183-2(b) lists nine factors that may be considered in determining whether an activity was engaged in for profit. No single factor, nor the existence of a majority of the factors, is necessarily determinative in any given case. *Ibid.*; *Nickerson* v. *Commissioner*, 700 F.2d 402, 404 (7th Cir. 1983). The factors listed in the regulations were derived principally from the case law developed prior to enactment of Section 183. See *Faulconer* v. *Commissioner*, 748 F.2d 890, 894 (4th Cir. 1984).

[4] The regulations under Section 212 (Treas. Reg. § 1.212-1(c)) indicate that the inquiry as to profit motive under that Section is to be determined by reference to Section 183 and the regulations issued thereunder. This cross-reference to the regulations under Section 183 belies petitioner's claim that the profit standard under Section 183 is different from that under Section 212.

motive required by section 183 [is] the same as the profit motive required by sections 162 and 212"); *Faulconer* v. *Commissioner*, 748 F.2d 890, 893 (4th Cir. 1984) (the "regulations under section 183 * * * explicate the profit-motive requirements of sections 162 and 212"); *Tallal* v. *Commissioner*, 778 F.2d 275, 276 (5th Cir. 1985) (criteria in regulations under Section 183 used to determine whether partnership had bona fide profit motive under Section 162); *Hayden* v. *Commissioner*, 889 F.2d 1548, 1552 (6th Cir. 1989) (referring to Section 183 in determining existence of profit motive); *Independent Electric Supply, Inc.* v. *Commissioner*, 781 F.2d 724, 726-727 (9th Cir. 1986) ("the courts have relied on the section 183 factors in conducting the profit motive analysis under section 162"); *Brannen* v. *Commissioner*, 722 F.2d 695 (11th Cir. 1984) (applying factors listed in regulations under Section 183 to determine whether taxpayer's activities were engaged in for profit under Section 162); *Dreicer* v. *Commissioner*, 665 F.2d 1292, 1294 (D.C. Cir. 1981) ("a taxpayer claiming a deduction under Section 162 or 212 for an expense, or under Section 165 for a loss, must be prepared to demonstrate an associated profit motive in order to avoid the ban of Section 183").

The Fifth Circuit has explicitly rejected the claim that it is error for the Tax Court to consider the regulations under Section 183 in determining whether the requisite profit motive existed. *Agro Science Co.* v. *Commissioner*, 934 F.2d 573, 576 (5th Cir.) ("contrary to [taxpayer's] assertion, the Tax Court appropriately looked to the factors listed in 26 C.F.R. § 1.183-2(b) (1990) in discerning profit motive bona fides"), cert. denied, 112 S. Ct. 300 (1991). There is no authority for petitioner's claim that the Tax

Court erred by considering the Section 183 regulations in this case.

2. Petitioner's reliance on cases holding that the Tax Court may not decide a case on a new issue raised for the first time after trial (Pet. 6) is misconceived. As the court of appeals correctly concluded in this case (Pet. App. A39), the application of Section 183 and the factors enumerated in the accompanying regulations to the profit motive inquiry did not present a new issue, for VEMCO's profit motive was at issue throughout the case. The notices of deficiency issued to petitioner by the Commissioner raised the absence of a profit motive as one of the grounds for the disallowance of the claimed partnership deductions (*ibid.*). The Commissioner's counsel emphasized in opening statement at trial that it was incumbent upon petitioner to prove that the expenditures were incurred for a profit motive (*ibid.*). Petitioner's counsel also recognized at trial that the critical question in the case was the motive for the mining activties that generated the disputed loss deductions (*ibid.*).

There was thus no new issue involved. Instead, the Tax Court simply considered the factors enumerated in Treas. Reg. § 1.183-2(b) in deciding the issue that was central to the case. As the court below correctly concluded, application of those factors in considering the profit motive issue was "predictable and nonprejudicial" (Pet. App. A41).[5]

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[5] Petitioner could not, in any event, have been prejudiced by the Tax Court's reliance on the factors enumerated in Treas. Reg. § 1.183-2(b) because those factors are derived from case law developed prior to enactment of Section 183. See *Faulconer* v. *Commissioner*, 748 F.2d at 894; *Benz* v. *Commissioner*, 63 T.C. 375, 383 (1974).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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NO. 91-1665

In the Supreme Court of the United States

OCTOBER TERM, 1991

CHARLA GATES CANNON,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent

REPLY BRIEF FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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QUESTIONS PRESENTED

The litigants in this income tax case tried and briefed the case in the issues of whether the stipulated expenses were deductible as business expenses or for the production of income. The Tax Court disallowed the expenses on the ground they were hobby losses. The Tenth Circuit affirmed. The questions presented are:

> Was it reversible error to sua sponte construe the hobby loss provisions in pari materia with those involving business expenses?
>
> Should the case be remanded to the Tax Court to afford petitioner the opportunity to offer evidence on the hobby loss issue?

Argument

On brief respondent asserts the decision of the court of appeals does not conflict with any decision of this court or of any court of appeals. Respondent does not discuss nor distinguish, nor in fact even mention, the decisions of the Eighth, Third, Ninth, and Fourth Circuits requiring "fair notice" to the taxpayer, cited and discussed on pages 6 and 7 of Petitioners Writ of Certiorari, nor the statutory limitation in Section 183(c) that the hobby loss provisions therein are not applicable if Sections 162 or 212 are.

It is undisputed that the factors under Section 183 can be applied to determine a profit motive under other sections of the Internal Revenue Code. The issue is whether the Tax Court can do so sua sponte without notice to the parties. In its opinion the Tenth Circuit expressly acknowledged that Section 183 was not considered by the litigants.

Respondent does allege that the provisions of Section 183 and the Regulations thereunder may properly be utilized sua sponte in resolving the existence of a profit motive under Section 162 and 212, citing several cases. However, in each case the applicability of Section 183 was litigated in the trial court with the consent of the parties. There was no surprise. Each of the cited cases are discussed in the appendix.

It is respectfully submitted that this case should be reversed or at a minimum remanded to provide petitioner her day in court to respond to the provisions of Section 183 or any statute the Commissioner would assert, perhaps by summary reversal.

Respectfully submitted,

TOWNER SHIELDS LEEPER

APPENDIX

Agro Science Co. v. Commissioner, 934 F.2d 573 (5th Cir.) cert. denied, 112 S. Ct. 300 (1991), affirming T.C. Memo 89,687 which denied deductions for research and development expenses under Section 174. The parties at trial applied the standards of Regulations under 183. Surprise was not an issue at either the trial or appellate level.

In *Antonides v. Commissioner,* 893 F.2d 656 (4th Cir. 1990) affirming 91 T.C. 686 the applicability of Section 183 was expressly raised and addresed by the litigants in the trial court.

In *Benz v. Commissioner,* 63 T.C. 375 (1974) Section 183 was expressly addressed by the parties and the trial court.

In *Brannen v. Commissioner,* (11th Cir. 1984) 722 F.2d 695, 53 AFTR 2d 84-579, affirming (1982) 78 T.C. 471 (Full Tax Court Opinion) the applicability of Section 183 was expressly raised in respondent's notice of deficiency and litigated by the parties.

Carkhuff v. Commissioner, 425 F.2d 1400 (6th cir. 1970) involved taxable years prior to the enactment of Section 183. Surprise was not at issue.

Commissioner v. Groetzinger, 480 U.S. 23 (1987) involving the issue of whether a full time gambler's income was a trade or business. Neither Section 183 nor surprise was at issue.

In *Dreicer v. Commissioner,* (Ct. of Appeals, D.C. 1981) 665 F.2d 1292, 48 AFTR 2d 81-5884, reversing and remanding (1979) T.C. Memo 79-395, Section 183 was ex-

pressly raised and litigated by the parties. The appellate court reversed for the provisions of Section 183 did not require a "bona fide expectation of profit."

In *Fauconer v. Commissioner,* (4th Cir. 1984) 748 F.2d 890, 55 AFTR 85-302, reversing (1983) T.C. Memo 83,165, the sole and expressed issue litigated by the parties was Section 183.

In *Hayden v. Commissioner,* 889 F.2d 1548 (6th Cir. 1989) affirming T.C. Memo 88,310, Section 183 was addressed by the parties and the trial court. No surprise was at issue.

In *Independent Elec. Supply, Inc. v. Commissioner* (9th Cir. 1986) 781 F.2d 724, 57 AFTR 2d 86-665, affirming sub nom Paul Lahr (1984) T.C. Memo 1984-472, the taxpayer expressly relied on Section 183 and unsuccessfully argued he had carried his burden of proof.

In *Nickerson v. Commissioner,* 700 F.2d 402 (7th Cir. 1983) reversing T.C. Memo 81,321 the sole issue litigated was Section 183.

In *Tallal v. Commissioner,* 778 F.2d 275 (5th Cir. 1985) the sole issue releated to Section 162. Neither Section 183 nor surprise was at issue.

Thomas v. Commissioner, 792 F.2d 1256 (4th Cir. 1986) affirming 84 T.C. 1244 which denied mining expenses under Section 616. Section 183 was not involved at the trial nor appellate level.

Wrightsman v. United States, 428 F.2d 1316 (Ct. Cl. 1970) involved years prior to the enactment of Section 183 which was not considered.